THE DOLLAR'S FUTURE • HOW TO HANDLE THE PRESS • THE AIR TRAVEL MESS

JUNE 19, 1989

# FORTUNE

# AT&T STARTS TO SCORE

## How CEO Bob Allen is changing America's most entrenched corporate culture

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JUNE 19, 1989

# FORTUNE

**ABOVE: Bob Allen being made up in Washington, D.C., for a TV appearance, photographed by Louis Psihoyos—Matrix.**

**COVER: Psihoyos snapped Allen at Baltusrol Golf Club in Springfield, New Jersey.**

**"The best decisions get made for the customer much further down in the organization."**

PAGE 58


MANAGING/Cover Story

**BOB ALLEN RATTLES THE CAGES AT AT&T** 58

This quiet executive went through a profound personal and professional reassessment when Jim Olson, his friend and predecessor as CEO, died in office. Allen's conclusion: The company's culture must change—and so must he. "Every one of us can fall into the trap of thinking, 'I don't need to change,' " he says. Allen went on to do things no AT&T CEO had ever done before. The results are beginning to show up, and even some competitors have words of praise. *by Andrew Kupfer*

MANAGING

**SMART WAYS TO HANDLE THE PRESS** 69

As Exxon's ordeal shows, dealing with reporters can be tough. Here are 14 guidelines for businesses to follow. *by Stratford P. Sherman*

THE WORLD

**HOW CHINA'S CHAOS AFFECTS THE WEST** 77

Whatever the immediate outcome, communism is in crisis worldwide. We should cheer, not fear, the reform forces from Beijing to Budapest, Moscow to Warsaw. *by Richard I. Kirkland Jr.*

POLITICS & POLICY

**SHOULD AIRLINES BE REREGULATED?** 82

No. Deregulation has been a triumph overall, and recent talk of rolling it back makes little sense. But Washington still must ensure that competition survives. *by Kenneth Labich*

EXECUTIVE LIFE

**HOW A TOP BOSS MANAGES HIS DAY** 95

You'll find Bob Lutz, Chrysler's No. 1 operating executive, in lots of meetings, visiting people—and rarely behind a desk. *by Alex Taylor III*

THE ECONOMY

**ARE WE TOO SCARED OF INFLATION?** 105

We sure are, say some dovish economists, and it isn't worth a recession to cure it. They think we can live with steadily rising prices. Trouble is, they're *wrong*. *by Charles G. Burck*

VOL. 119, NO. 13

"We buy in the face of the fear and sell when everyone else is getting greedy."

PAGE 49

"They were hard up, and he took their pants off."

PAGE 114

"More and more, industry is asking: 'How do we get people trained *before* we hire them?' Vocational schools do this."

PAGE 127

"If you look at it today, it sounds totally crazy. But those were the go-go days of biotech."

PAGE 141

"I really believe our ultimate competitive advantage is that we essentially went broke."

PAGE 147

"Women tend to be more human. And more of them working can create a new image for Japan."

PAGE 153


## MONEY & MARKETS

**THE SCREWIEST S&L BAILOUT EVER** 114

After wealthy Texans ran the huge thrift into the ground, the feds sold it to billionaire Ronald Perelman for a song. The old owners came out well. But the taxpayers? *by Brett Duval Fromson*

## EDUCATION

**THE NEW, IMPROVED VOCATIONAL SCHOOL** 127

Worried about the shortage of technicians? Can't find people who can communicate and solve problems? Here's hope. *by Nancy J. Perry*

**WEST GERMANY'S COMPETITIVE ADVANTAGE** 136

## ENTREPRENEURS

**WHAT A WAY TO START A COMPANY!** 141

SmithKline has put more than $70 million into Nova Pharmaceutical, which didn't even have a lab before it went public. *by Gene Bylinsky*

## CORPORATE PERFORMANCE

**COMPANIES TO WATCH** 147

Continental Bank comes back. Plus: Loctite, Westmark International, Crown Crafts, and J&J Snack Foods.

## JAPAN

**JAPAN DISCOVERS WOMAN POWER** 153

Labor-short Japanese companies are making managers of young college graduates once condemned to be mere office ladies. *by Sally Solo*

## DEPARTMENTS

**EDITOR'S DESK** 4

**INDEX** 6

**NEWS/TRENDS** 8

The shrinking business globe, Wall Street complains about corporate pay, and more.

**FORTUNE FORECAST** 19

Put the dollar in perspective: It's way below the peak, and will drop again by year's end. Exports are safe. *by Vivian Brownstein*

**PERSONAL INVESTING** 49

Bonds that look good now. *by John J. Curran*

Also: Which rails to ride, getting service from full-service brokers, and Portfolio Talk with Roger D. Newell of Newell Associates.

**FORTUNE PEOPLE** 161

Roy Bostock's red meat diet, shareholder Abbott Leban, and more. *by Mark Alpert*

**ON THE RISE** 162

**BOOKS & IDEAS** 187

In a brash work that will provide plenty of fuel for creative arguments, Peter Drucker tells how the world has changed. *by Paul Johnson*

**LETTERS TO FORTUNE** 191

**KEEPING UP** 195

The Senate's superliberal, unfree speech at Berkeley, and more. *by Daniel Seligman*

**OFFICE HOURS** 201

Your subordinates can tell you how to be a better manager. *by Walter Kiechel III*

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# EDITOR'S DESK

NINA BARNETT

**AT&T watcher Kupfer where FORTUNE's phones ring**

CAN A LOW-KEY executive who nearly ended up running his father's Midwestern clothing store turn a galumphing Goliath of American business into a quick-witted global competitor? That is the question writer Andrew Kupfer pursues in this issue's cover story on Robert Allen of AT&T. Thrust into the chief executive's job unexpectedly after the sudden death of his predecessor a year ago, Allen kept the press at a distance for quite a while. What made him willing to open up to FORTUNE? "He spent his first year thinking about what he had to do and making some very big changes," says Kupfer. "Now he wants to report some progress."

From Allen's point of view, FORTUNE was a natural choice for his first major profile. We have chronicled AT&T's and the Baby Bells' progress in a dozen or more stories—from a prescient special report just before the "big bang" shattered the phone monopoly in 1984 to a critical assessment last January of the breakup's effects. Several of those articles greatly benefited from contributions of reporter Kate Ballen, who joined Kupfer in interviewing myriad competitors and ex-AT&Ters to gain perspective on Allen and his achievements so far. "At 54, Allen is the youngest CEO in almost 40 years," Ballen notes, "and he will have more impact on the company than many before him."

ROBERT WALLIS—SPA

**Sally Solo**

Kupfer's skill in drawing out business leaders was sorely tested in his first encounter with his subject. Scheduled to accompany Allen on a 7:30 A.M. plane trip to Florida, Kupfer made a trial run to the Morristown, New Jersey, airport and spent the night nearby. But when he arrived the next morning at what he had been told was the appointed hour, he found a frosty Allen, who had nearly ordered the plane to take off without him. It turned out that the flight was really supposed to leave at seven. How did Kupfer get the CEO to warm up again? "I had my sheaf of questions," he says, "but I asked him instead about an old acquaintance of his whom my wife had worked for."

Also in this issue you will find the surprising story of a quiet revolution sweeping Japan: Young women, once content to be decorous office ladies until marriage, are starting to invade the male-only management ranks. The author, reporter Sally Solo, who has been living and working in Japan on and off for the past ten years, confesses that she never expected to write this story. International editor Donald Holt agrees: "We've been watching the huge buildup of well-educated women on the one hand and a growing labor shortage on the other and wondering, 'When will it happen?' " As Solo's engaging report on female auto designers, investment bankers, and advertising executives proves, when it will happen is now. And what it will mean is plenty.

Marshall Loeb

MANAGING EDITOR

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*The Yokois in their U.S. home*

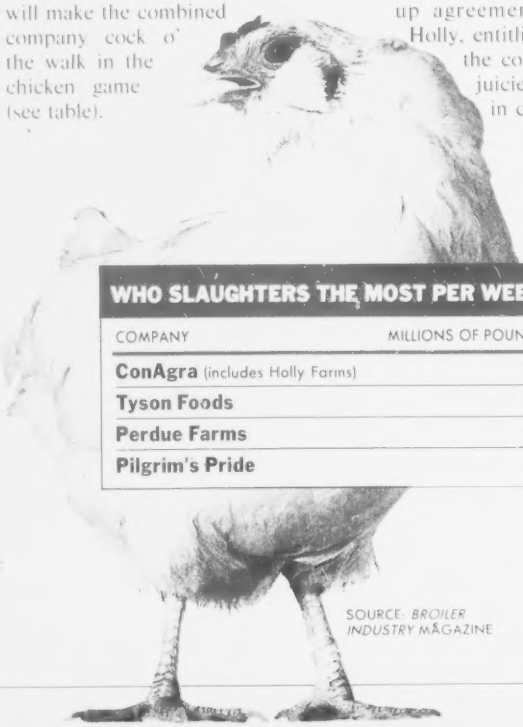
hometown of Nagoya, about 170 miles south of Tokyo, and was introduced to seven different single women by a matchmaker. His pick: Atsuko Kawasumi, who tested new products at **Brother Industries**, a maker of typewriters and fax machines. Yokoi took her out eight more times for walks and coffee-shop talks. At the end of his two-week trip, Yokoi was an engaged man. Says he: "I felt relieved, not so much because I had found a fiancée but because I could escape the ribbing of my friends and associates." Tokai paid his round-trip fare back to Nagoya for the November wedding and even gave the groom a few extra days off for a honeymoon in Hawaii. The couple now live in Cliffside Park, New Jersey.

Sumitomo Bank gives its bachelors two chances to find a mate. It pays the full round-trip air fare for the first trip and half for the second. So far, only Japanese men have used this special leave. For one thing, career opportunities for Japanese women generally have barred them from foreign postings, though things are changing (see Japan).

Courtship leaves reflect the paternalistic practices that all Japanese companies espouse. Conglomerates like the **Mitsubishi** and **Mitsui** groups even have matchmaking services in Japan. Says one bank executive: "It's the company's obligation to give employees a chance to get married." – **F.H.K.**

## BROILER WARS

■ Don Tyson, the chief executive of **Tyson Foods**, the country's biggest chicken processor, has been heard to kid analysts that he loves to kick the competition when they're down. It may be Tyson's turn for a taste of the boot. His seven-month pursuit of **Holly Farms**, another chicken processor, seems to have been ended by **ConAgra**, the food company that has agreed to acquire Holly for $1.32 billion in stock. ConAgra's average 1988 weekly kill of 41.7 million pounds and Holly Farms' 31.7 million pounds will make the combined company cock o' the walk in the chicken game (see table).



**WHO SLAUGHTERS THE MOST PER WEEK**

| COMPANY | MILLIONS OF POUNDS |
|---|---|
| **ConAgra** (includes Holly Farms) | 73 |
| **Tyson Foods** | 58 |
| **Perdue Farms** | 30 |
| **Pilgrim's Pride** | 20 |

SOURCE: *BROILER INDUSTRY MAGAZINE*

The Holly board of directors turned tail and headed for ConAgra's protective wing soon after Tyson made his intentions known last October. The feathers have been flying ever since. Holly's shareholders rejected their board's first merger agreement with ConAgra in April, preferring Tyson's $63.50 all-cash offer. ConAgra had a lock-up agreement with Holly, entitling it to the company's juiciest parts in case of a takeover by a third party. The Holly board put the company up for auction. ConAgra eventually emerged as the winner after a nasty court battle. But the chicken world clearly hasn't heard the last cluck from Don Tyson. – **Bill Saporito**

*A father-son talk: James and Laurence Tisch, betting on oil rigs*

## AN INVESTMENT TIP FROM THE TISCHES

■ Attention contrarian investors willing to wait for a payoff: Here's a chance to ride the coattails of the billionaire Tisch family. Through their **Loews** holding company—which owns **CNA Financial** insurance, **Lorillard** tobacco, and other properties, including 25% of **CBS**—the Tisches are buying offshore oil rigs, this at a time when the drilling services industry is barely afloat. They have already picked up three rigs from **Cliffs Drilling** for about $5 million apiece and plan to buy another seven from **Kaneb Services**. All are in the Gulf of Mexico.

James S. Tisch, executive vice president of Loews and son of CBS Chairman Laurence A. Tisch, explains the basic proposition: A worldwide glut of rigs and a flotilla of drillers up to their necks in debt equals a

# BOB ALLEN RATTLES THE CAGES AT AT&T

Taking over at a tragic moment, this quiet CEO went through profound introspection. His conclusion: The company's culture must finally change—and so must he. ■ *by Andrew Kupfer*

**Now used to the public requirements of his job, Allen is made up for a TV interview.**

MRS. OLSON called me early Monday morning just after Jim died—5:29 to be exact. I had seen him at dinner on Friday, and knew there was some deterioration over the weekend, but no one expected his death. Barely before I was awake I was on the telephone with the other top officers. I got them all out of bed. We gathered that morning and began to make plans.

"We were all terribly distraught, but there was so much to do. It was really not until later that we had the time to mourn. Jim was such a vibrant and dynamic person. He really touched the lives of an awful lot of AT&T people, so it was a shock, and a particularly emotional burden for me because he had also been a good friend. I was aware that I was Jim's choice [to succeed him] and that I would probably be the board's choice. But I really thought I had another year or two to prepare."

On April 19, 1988, the day after James Olson died at 62 of colon cancer and the day before the company's annual meeting, Robert Eugene Allen was elected chairman and chief executive of AT&T. What a way to take over America's largest diversified service company. And what a time. AT&T was losing share in the all-important long-distance market—the major business that the consent decree allocated to it in the 1984 break-

REPORTER ASSOCIATE *Kate Ballen*

PHOTOGRAPHS BY LOUIS PSIHOYOS—MATRIX

up. Within a week of Allen's appointment, the head of the computer operation—one of the company's big bets for long-term growth—quit. At the same time a joint venture with Olivetti of Italy was unraveling, and with it the hope that this quintessentially American company could throw off its fetters and compete globally in the computer market.

Psychologists say that the death of a friend can lead a person to profoundly reassess his life. Allen went through that wrenching experience, both personally as Olson's friend and professionally as his successor. This story presents the emotional process and the concrete results of that introspection. Allen says, "Jim's death caused me to pause for a few months and rethink a lot of things about the business, about where we ought to go and how I ought to lead."

**"Every one of us can fall into the trap of thinking, 'I don't need to change.' It's like drug or alcohol addiction."**

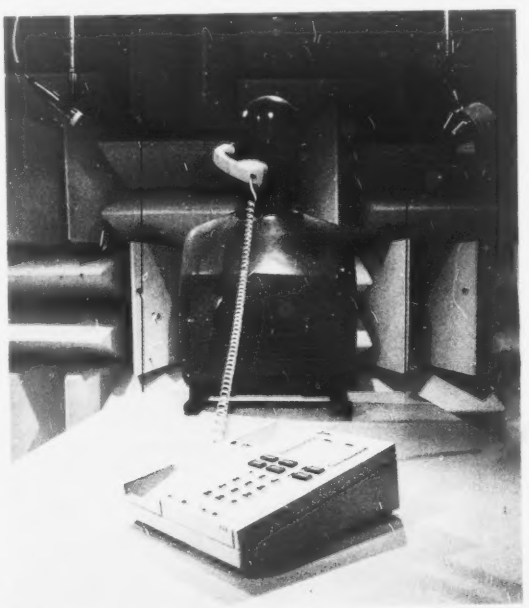
HIS MAJOR CONCLUSION: that AT&T, the most entrenched corporate culture in America, must finally change and change for good. People had been talking about this need ever since divestiture, but too little had happened. The company could no longer operate as the regulated monopoly it once was, satisfied with predictable price increases, complacent about competition, uncritical of costs. To compete in fast-changing markets—for that is where divestiture has taken all AT&T's businesses—the phone company of old had to learn to get aggressive, to take chances, and above all, to move quickly.

Allen came to realize that the cultural revolution had to start with him. "Every one of us can fall into the trap of thinking, 'I don't need to change,' " he says. "It's like drug or alcohol addiction. You first have to face up to the fact that you've got a problem." In his first year as chief executive, Allen took strides no predecessor had ever taken. By writing down $6.7 billion in obsolete transmission equipment, he produced a $1.67 billion annual loss, the first since AT&T was incorporated 104 years ago. By spending $250 million to acquire Paradyne Corp., a competitor that manufactures data communications equipment, he signaled the end to the not-invented-here syndrome, a self-defeating sense of smugness that permeated a company where so much had, in fact, been invented.

As for his own style? "I've changed in that I'm not only tolerant of contention, but I encourage it," says Allen. "I am becoming more comfortable with decision-making being much further down in the organization, because that's where the best decisions get made for the customer."

Middle managers are gaining authority. Recently Allen met with several who presented an interim report on a new product proposal. He surprised them by giving the final go-ahead on the idea, even though a feasibility study would not be complete for several months. His decision was meant to make waves beyond that particular project. He says, "It was refreshing to them that I could hear the facts, ask a few questions, make a crisp decision, and turn them loose. Maybe that ought to be normal behavior, but it hasn't been normal behavior around our business." And Allen still has a way to go in eliminating petty procedures. A former executive who just left to work for a competitor recalls, "I was a manager overseeing a construction budget of $150 million, but I had to get approval to travel."

Though much remains to be done, Allen's first year has produced a string of victories. He is reorganizing the company—yes, again—but this latest shuffle should finally help it play a more competitive game. AT&T has won big government contracts, succeeded in important regulatory battles, and arranged a new venture with Italy's state-owned telephone company that will get it flexing unused muscle overseas. First-quarter profits were up 21%, and the stock price has risen almost 40% since August to a recent $34.625 a share. Even William McGowan, head of long-distance archrival MCI, has words of praise for AT&T's managers: "They certainly demonstrated that they realize they have to be more aggressive on costs and on customer responsiveness."



**This funny-looking guy helps test the sound quality of phones in an anechoic (echo free) chamber in Indianapolis.**

TALK TO people who know Bob Allen and they almost invariably describe him as a good listener. Those who don't really know him will say that he is, well, kind of dull. They point to his soft-spoken, low-key manner, his absence of flair. "Most people say I'm quiet and reserved, and by comparison to Jim Olson I suppose I am," says Allen. "He was quite an outgoing person, and had more energy than anybody I ever knew." Still, Allen is witty, albeit in a subdued sort of way; stubborn, yet smart enough to know when to change; a less than rousing speaker, yet an effective motivator.

When he talks about what he is trying to do at AT&T, he gravitates toward the timeless mantras of manager-speak: "quality, quality, quality"; "customer, customer, customer"; "teamwork, teamwork, teamwork." But when he reminisces, you hear about an all-American past steeped in values that give those phrases resonance.

An only child, Allen was born in Joplin, Missouri, in 1935. When he was 5, the family moved to New Castle, Indiana, a town of 20,000, where Chrysler is still the biggest employer. It is Indiana that Allen calls his home. He learned his first lessons about risk taking from his father, Walter, who quit his job of 21 years with the Newberry chain of five-and-dimes to buy a bankrupt children's clothing store. "Talk about

courage and entrepreneurship," says Allen. "It was totally out of character for him, as I think it would have been for almost anyone who lived through the Depression. But he just didn't want the grief of working for someone else anymore."

Walter rescued the business by specializing in high-quality merchandise. "His clientele ranged from people who could afford the best at almost any price to people who really would have to scrimp to put nice clothes on their kids' backs. He always stood behind his products and delivered them himself, and if anyone wanted to return something, he would take it back without question. I learned a lot just from observing his focus on customer satisfaction."

ALLEN HAS HELD a job since he was 8 years old. "God, I can't remember all the jobs I've had," he says. "I had a paper route and I cut grass. I worked in a men's clothing store. I cleaned house. I worked as a mechanic's helper. I worked on a pipeline—most difficult physical job I ever had—13 hours a day and seven days a week, unless it poured down rain. I worked on a surveying crew. I tassled corn one summer—boy, that's a pain in the ass. I don't even remember why we did it; something to do with cross-pollination. And I worked on a railroad gang, straightening track. There were eight blacks and me. They called me the college boy. I learned about a whole variety of people, what makes them tick and what motivates them. It gave me respect for people who do work that most of us don't think is particularly attractive."

The work paid for almost all of Allen's education at Wabash College, a men's school 80 miles away in Crawfordsville, Indiana, where he studied political science and economics. He honed his competitive instincts on the gridiron, playing end for Wabash the year it was selected as the all-state small-college team—"to my own amazement," he says, "and probably to the amazement of some of my teammates." (These days he plays golf—7 handicap—and jogs to keep fit.)

One game haunts him still. "We were playing Heidelberg, the No. 1 small-college team in the country, and we lost 14–13. One of the jobs I had on the team was filling the holes on the football field to be sure it was level. Late in the game I had a chance to intercept a pass in the flat, only 20 yards from the goal line. I could taste it. I could see it. And just as I reached out, I stepped in a hole and tripped just enough so that I could reach out and touch the ball, but I couldn't intercept it. To this day I've always thought about that game when I think of quality. If I had done the damn thing right, I'd have intercepted the pass and we would have won the game."

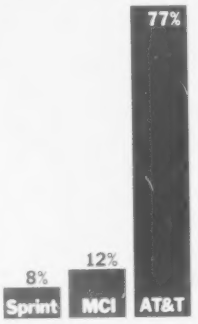
After his junior year, Allen married a hometown girl who was attending nearby DePauw University. "I think his calmness attracted me," says Betty Allen. "Bob and I are very different. He's very low key, and I'm a talker. Bob was just a very, very kind and considerate person. And there was never any doubt in my mind that he would do well—not that I ever in my wildest dreams thought that he would be chairman of AT&T."

Allen's plans to go to law school evaporated when the first of the couple's five children arrived three days before graduation. He was offered jobs at IBM and Procter & Gamble but preferred Indiana Bell instead. His first assignment brought him to the heart of the business: As a traffic engineer, he mapped the most efficient pathways for telephone calls to follow through the local exchange's network of electromechanical switches. Next he supervised chief operators, who ran the company like master sergeants in those days. "You didn't dare dictate anything to the chief operators," he says. "I suspect I learned to sell there for the first time." He first met Jim Olson at Indiana Bell, and when Olson was president, he was secretary-treasurer.

In 1960—Allen was still in Indiana—his father decided to retire. "He offered me the business," says Allen. "He laid it all out and showed me where he'd been and where he thought the store could go. It wasn't a big business by any means, but with three or four kids by that time and a grocery cupboard that was kind of bare, I must say it was very

## LONG-DISTANCE WARS

**It towers dramatically over competitors MCI and Sprint, but AT&T has seen its share of the long-distance market fall 13 percentage points since divestiture.**




ESTIMATES EASTERN MANAGEMENT GROUP

BARTH HASENSTEIN

**No more switchboards in Columbus. Ohio long-distance operators have a $40 million computer system.**

attractive. But after he got finished, he said, 'It's all yours if you want it, but I wouldn't recommend that you take it.' " Allen didn't.

Staying the course in the Bell System, he moved to Bell of Pennsylvania, then to Illinois Bell, then to AT&T as a vice president, and then to Chesapeake & Potomac Telephone Cos. as president. Six months before the breakup, Allen arrived at AT&T headquarters in Basking Ridge, New Jersey, as chief financial officer. Two years later he took charge of Information Systems. He brought cost cutting to that troubled office automation division, but not the winning strategy it needed. Named president and chief operating officer in 1986, Allen was being groomed for the chairmanship when fate gave him the job sooner than he expected.

SETTLING INTO his seat on the corporate jet, Allen stretches his legs and sighs. He has spent this day of May in Largo, Florida, at Paradyne Corp., his first visit since AT&T bought the company in February. His new troops—AT&T managers often refer to employees as troops—received him warmly. But now his body aches. "I have flat feet," he confesses, "so these plant tours kill me."

The Paradyne purchase is part of Allen's strategy to put AT&T's monopoly-era mentality into permanent amnesia. "We came out of a business that had a single culture," he says. "It was very paternalistic, thorough, slow-moving, and exceptionally proficient in accomplishing its mission, but in a static environment." AT&T didn't have to worry about speed in bringing out new products—it controlled the technology *and* the market. If the company took an extra year to develop a new office telephone system—hey, no problem, it would just sell the old one a little bit longer. Now, says Allen, "if you miss a year, you've missed a whole generation of products." The Paradyne deal demonstrates a quicker way to fill holes in AT&T's product line than internal development.

Paradyne was a good match for AT&T. It is a leading manufacturer of modems that let business computers communicate over nondigital phone systems. Besides, the Florida company had a solid base of business customers in the U.S. and a strong sales force overseas. But Paradyne had troubles too: Its reputation was still suffering from a scandal eight years ago, when it was caught trying to win a government contract for an encryption device with a bogus prototype. Its credibility now enhanced, AT&T Paradyne, as the business unit is called, has already won a million-dollar contract from Deloitte Haskins & Sells, the Big Eight accounting firm.

The latest reorganization—there have been about a half-dozen since divestiture—aims to bring AT&T's businesses closer to the customer. Now 19 business units are organized by product line, such as business communications, switching systems, and network computing systems. Each unit will be responsible for its own profits and losses and will have the authority to make decisions on pricing, marketing, and product development. Says vice chairman Randall Tobias, who is in charge of putting the structure into place: "This is a fundamental change in the way we run the business."

In fact, it essentially reverses Jim Olson's old scheme. In his attempt to reorganize the company, Olson consolidated the long-distance organization with the phone and computer groups. His structure had a sensible rationale: The units he inherited, particularly those that sold computer products, behaved like separate fiefdoms and often approached customers with different solutions to the same problem. Says John Malone, president of the consulting firm Eastern Management Group: "You could measure in nanoseconds how long it took the customer to reach the boiling point." To keep customers cool under the new regime, the group presidents will have to make sure that the business units don't go back to getting in one another's way. For large customers, sales reps will work in teams, with members present from each unit that does business with the client.

THE SMALL-COLLEGE football star is encouraging new approaches to competition—especially in the superwar over business telephone customers. The long-distance market is booming, thanks to rates that have dropped about 40% since 1984, the proliferation of 800 lines, and those increasingly ubiquitous fax machines. After getting battered by MCI and Sprint in television and print advertisements, AT&T has started getting tougher: Its ads now hit competitors by name.

The head of marketing for the $14-billion-a-year unit that sells long-distance service to businesses is Joe Nacchio, 39, a frank, fast-talking New Yorker with a Type A personality—the antithesis of the old AT&T image of the pasty-faced shut-in who sat at his desk taking customers' orders. In an innovative TV promotion last year, Nacchio offered small-business customers of MCI and Sprint a service guarantee: If they switched to AT&T and were unsatisfied for any reason, the company would pay to switch them back to their former carrier. The campaign attracted 28,952 new clients, and Nacchio says that only five have asked to be moved back.

Spurred on by improvements that MCI

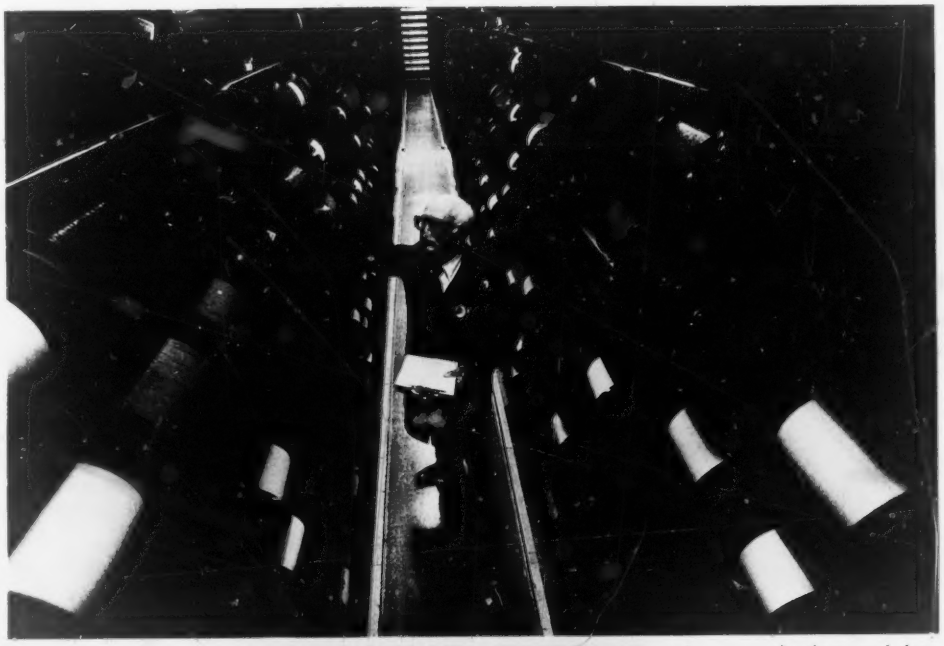
## HOW AT&T STACKS UP

| | REVENUES last 4 qtrs. $ millions | EARNINGS last 4 qtrs. $ millions | STOCK PRICE 5/23/89 | Change from 12/30/88 |
|---|---|---|---|---|
| **LONG-DISTANCE CARRIERS** | | | | |
| American Telephone & Telegraph | $35,520 | ($1,567) | $34.625 | 20% |
| MCI Communications | $5,506 | $434 | $39.25 | 73% |
| US Sprint | $3,630 | N.A. | $64.50* | 39% |
| **REGIONAL COMPANIES** | | | | |
| American Information Technologies | $9,988 | $1,243 | $59.375 | 24% |
| Bell Atlantic | $10,733 | $1,336 | $86.50 | 22% |
| BellSouth | $13,688 | $1,684 | $49.00 | 23% |
| Nynex | $12,825 | $1,288 | $77.625 | 18% |
| Pacific Telesis Group | $9,518 | $1,205 | $40.75 | 32% |
| Southwestern Bell | $8,511 | $1,080 | $51.75 | 28% |
| US West | $9,244 | $1,141 | $69.625 | 21% |

*Stock price for United Telecom, Sprint's parent.

**Though AT&T took a big loss in 1988, its stock has had a healthy run since the first of the year. Still, it trails the rivals' performance and that of most of the Baby Bells.**

and Sprint have made in their telephone networks. Allen is accelerating AT&T's program. After all, long distance is AT&T's biggest business, accounting for a little more than half of 1988 revenues. (Of the rest, over 20% comes from the sales of communication equipment and computers, and a little under 20% is from telephone transmission and switching equipment.) He has earmarked $3 billion in each of the next two years for network improvements, which will include replacing copper wire with optic fiber. This will make transmission cheaper and more efficient.



ALLEN'S PLANS for computers illustrate a cardinal rule for executives (and golfers): Find where your advantage lies. When he became CEO, the company's data-processing business was in turmoil. Its joint venture with Olivetti had descended into mutual mistrust. AT&T flopped selling Olivetti's personal computers in the U.S., and Olivetti couldn't move AT&T's minicomputers in Europe. Olivetti then infuriated AT&T by selling a competitive computer of its own on the Continent. To make matters worse, Vittorio Cassoni, an adept Olivetti manager whom AT&T borrowed to shore up its computer business, returned to Italy as Olivetti's managing director.

In the past year AT&T has continued its move away from plans to be a big seller of stand-alone computers. Instead the company is focusing on marketing computers arranged in networks to large customers—and if anything is AT&T's forte, it is networking. The company is also working hard to promote Unix, the computer operating system it developed. Though Unix is nonproprietary—open for others to copy—AT&T makes money from licensing the use of its version. As Unix proliferates, AT&T's influence in the industry will solidify: Software designers will write more applications that use the system, which in turn will create greater demand for networks that run on it. Under Robert Kavner, who had been the chief financial officer, the computer business expects to break even in 1990 for the first time after seven years of losses.

With competitive pressure and slow growth likely in many of AT&T's domestic businesses, Allen aims to make AT&T a full-fledged resident of the global village. According to the Eastern Management consulting firm, foreign markets account for 60% of worldwide spending on telecommunications and data processing. AT&T's international business remains piddling. Under a joint venture with Italtel, Italy's state-owned phone equipment manufacturer—the deal awaits government approval—AT&T will supply digital technology to Italtel. That's a colossal opportunity in itself: Italy's budget for network modernization is $28 billion over four years. The companies will also join to market and manufacture phone equipment for the European market.

The agreement gives AT&T a foothold in Europe just in time for the unification of 1992. It is also evidence that AT&T has learned from the experience with Olivetti: AT&T will press for a clear understanding with Italtel, so that the Italian company will not start marketing its own equipment without its American friend.

Big improvements though they are, these changes represent just the first stirrings of what Allen wants his company to be. Most troublesome to AT&T's future is the persistence of regulation in the long-distance market. The company has won victories in this arena: Most recently the FCC threw out rules that limited its profits to a designated rate of return. New regulations will

**1988 CAPITAL INVESTMENT**

**Competitors have spent billions on their networks. So AT&T is moving faster to install digital switches, fiber-optic cable, and other network technologies.**

**Spools of optic fiber (top) start out as glass rods (bottom) built up layer by layer.**

impose a price cap that ties maximum rate increases to inflation without limiting AT&T's earnings—and historically long-distance rates have been coming *down*. As long as competition allows, the company will now be able to keep much of the savings from cost cutting instead of having to pass all of them along to consumers. Michael Kennedy of the Arthur D. Little consulting firm estimates that within five years the price-cap rules will add 75 cents a share to earnings, estimated at $2.50 a share for 1989. AT&T also won the right to offer discounts to big business customers. Recently it asked the FCC if it could cut prices on long-distance services for consumers and small businesses by $140 million annually.

What AT&T really wants is the same hands-off treatment as Sprint and MCI. The FCC considers AT&T to be the "dominant" long-distance carrier, so the agency retains the right to approve any discounts to make sure they are not predatory. AT&T general counsel John Zeglis counters that competitors have so much capacity that his company no longer has monopoly power, and the dominant tag is unfair. "It took us a year and a half to get Reach Out America approved," he says of AT&T's residential discount package. "MCI is about to initiate the same thing, and they can do it in a matter of days."

AT&T also has to worry about rearguard action by the Baby Bells, which are lobbying for legislation that would let them provide information services and make telephone equipment. AT&T will not oppose their attempt to create information, but is against their entry into manufacturing, which was forbidden to the regional companies under the terms of divestiture.

No matter how sharp a competitive spirit Allen can instill in the troops, AT&T will have a hard time growing in some of its biggest businesses. The company recently introduced Definity, a highly praised digital telephone system that can serve both large and small companies. But competition, mainly from Northern Telecom and IBM's Rolm, is stiff. AT&T fought hard to win 60% of a multibillion-dollar contract to replace the federal government's telephone system; Sprint has the rest of the business. But the present system was built and maintained by AT&T, so the company is just barely retaining its hold.

Another big problem: a predivestiture accounting system that does not precisely show how costs are associated with revenues. "In the long-distance business, at best AT&T knew what it was getting by state," says Kennedy of Arthur D. Little. "It still doesn't know if it makes money in New York City." The company is developing a new bookkeeping system.

Then there are the people, the 304,600 survivors of deregulation, reorganization, and top-management changes. Morale, to put it mildly, is shaky. Joel Gross, a telecommunications analyst with Donaldson Lufkin & Jenrette, says, "All the employees are optimistic about the company, but at the same time they are scared out of their minds about their jobs." Allen has not done anything to make them feel more secure: Last year's write-off has a provision for future staff reductions.

Predictably, there is trouble on the labor front. The week before contracts with the Communications Workers of America and the International Brotherhood of Electrical Workers expired, the union members voted to authorize a strike. A major issue: health care costs. Under the old contract AT&T paid every cent of medical care for employees and retirees, and their dependents—at a price of $1 billion a year. AT&T wants employees to pay more of their doctors' bills.

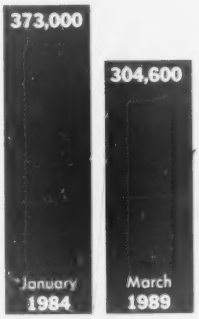
BECAUSE OF these impediments, financial analysts think revenue growth will be held to about 5% a year. But that's not too bad, considering that sales over the past four years rose a *total* of 6%. The biggest spur to earnings will be cost cuts, inspired by the price-cap ruling.

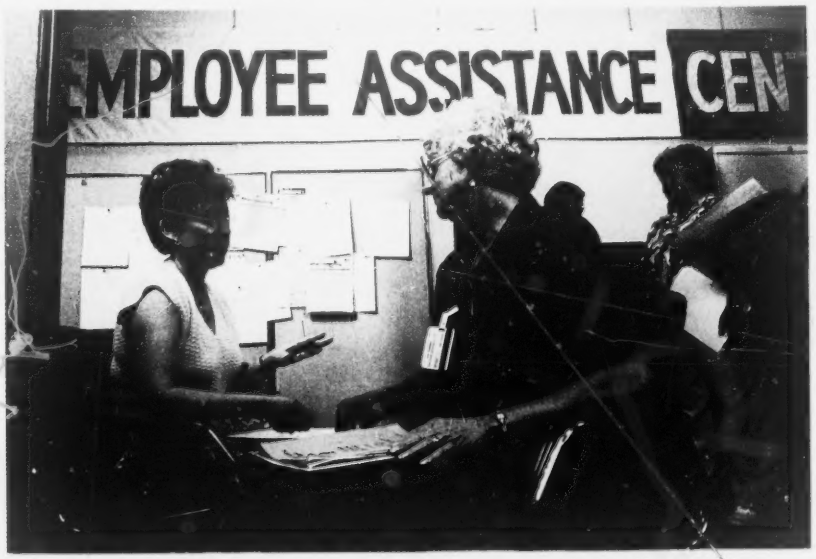
Perhaps the most encouraging sign for AT&T is that Allen is finally getting the company's managers to change. Says Gross of Donaldson Lufkin & Jenrette: "A lot of good young bulls below top management will carry the company into the 21st century." Members of this rising generation may bring AT&T all the way into the post-regulatory world. In the meantime one former chairman thinks the company is in good hands. "Allen can set priorities and articulate them so that people can understand them clearly," says Charles Brown, the man who led AT&T through the breakup. "He is an orderly person. He knows the business well. It is good for AT&T to have a steady person now."

And one who appreciates the importance of avoiding potholes. F

## AT&T'S SHRINKING WORK FORCE

**Two major rounds of job reductions—one of 24,000 and the other of 32,000—have helped reduce the troop strength 18% since the breakup. Morale has suffered.**




**A counselor gives advice to an 18-year employee who is being laid off in Winston-Salem.**

# ARE WE TOO SCARED OF INFLATION?

We sure are, say some dovish economists, and it isn't worth a recession to cure it. They think we can live with steadily rising prices. Trouble is, they're *wrong.*

■ *by Charles G. Burck*

FOR MORE THAN A YEAR the Federal Reserve has been tightening the money supply, and short-term interest rates now are some 2½ percentage points higher. The payoff may be coming, judging by such signs of slower economic growth as lagging industrial production and retail sales. But what if the Fed has been too rigorous, and the next recession is beginning to take shape? Must the U.S. murder its longest peacetime expansion in order to choke off inflation?

So far the Fed gets high marks for cutting down the oxygen without killing the patient. But inflationary pressures are building from growing wage demands at home and rising prices abroad. FORTUNE expects that inflation in the U.S. will reach a persistent 5.5% rate next year. That's far too high for comfort: If the Fed loosens its grip, the rate could go higher still.

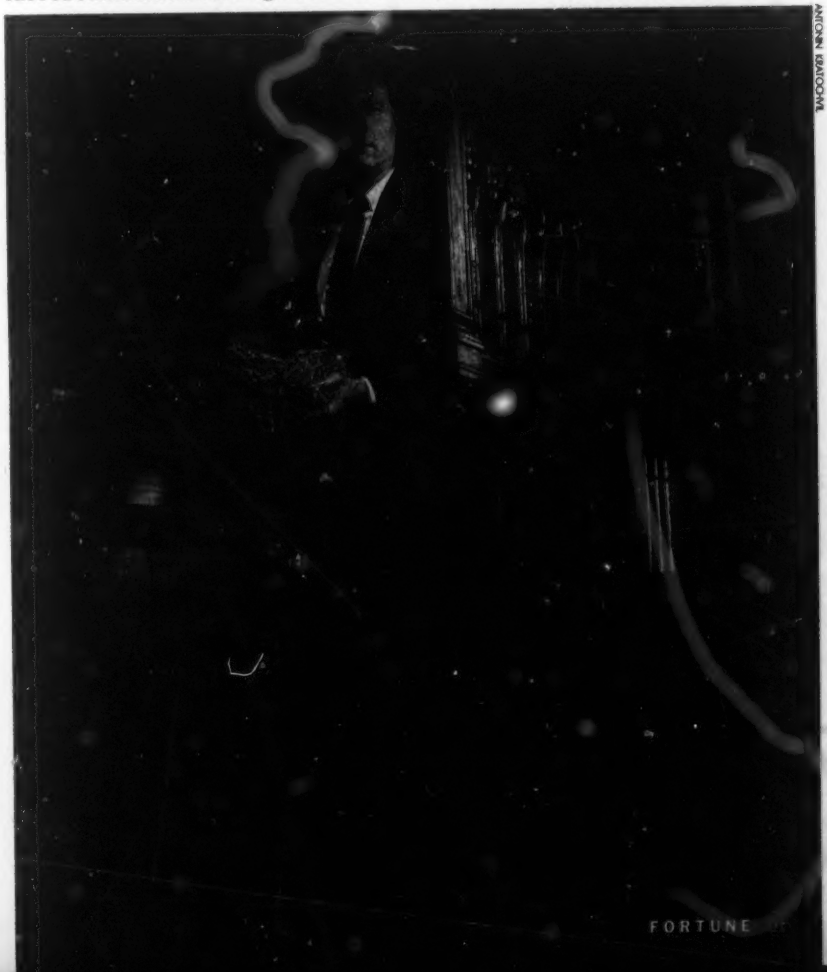
Some notable economists think all this nail biting is not necessary. Yes, they say, we should resist rising prices, but not with recession's brutal bludgeon. The cost to the nation is too high, the production that is lost through layoffs is gone forever, and there are less stinging ways to control rising prices. Ranged against these doves are such hawks as W. Lee Hoskins, president of the Cleveland Federal Reserve Bank, who argues that we should give no quarter in the war against inflation. The eventual goal, he says, should be none—zero, zip, *nada*—whatever the costs may be.

FORTUNE flies toward the hawkish end of the formation. By its nature inflation breeds the expectation that prices will rise even faster. Therefore, the least painful course over the long term is to dampen that expectation, even at the risk of a downturn. But recession is a blunt and mean instrument, and should it seriously threaten the economy, Congress will likely listen sympathetically to the doves and lean heavily on the Fed to reverse policy. If Congress bullied the Fed successfully, that would invite further inflation—and an even more painful correction eventually.

Recession exacts a punishing tax. By rule of thumb, unemployment would have to rise a percentage point from recent levels—that is, 1.2 million more people out of work—and stay there for a full year to knock just half a point off the inflation rate. The price tag: some 2% to 2.5% less GNP growth. Princeton economist Alan S. Blinder calculates that the total levy on the nation from excess unemployment between 1974 and 1986—much of it attributable to recessions—was a stunning $1.9 trillion in 1986 dollars. Add to this the penalty paid by investors in lower share values and lost divi-

REPORTER ASSOCIATE *Charles A. Riley II*

**The Fed's Hoskins: America's goal should be to reach zero inflation over three to five years.**



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FORTUNE

dends and the hardship meted out to the poor and near poor who lose their jobs. Blinder blames the recessions of 1980 and 1982 for raising the proportion of people living below the official poverty line from 11.7% in 1979 to more than 15% in 1983 and for contributing to the widening disparity of incomes in the 1980s.

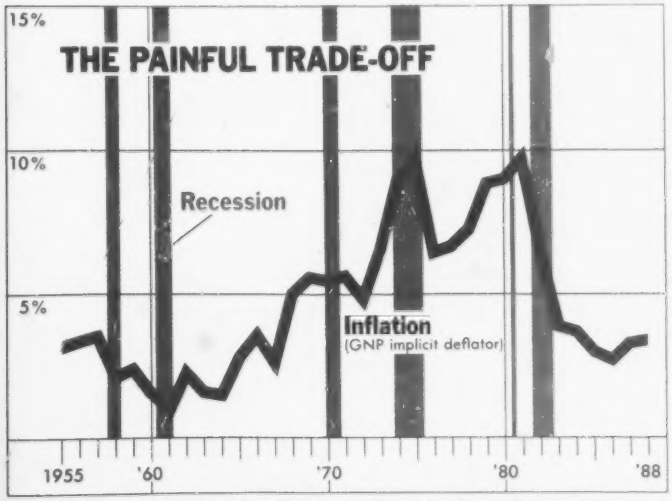
SHONNA VALESA

**Princeton's Blinder: The production that is lost as a result of recession is gone forever.**

WHAT A GRISLY TOLL, say the doves, who count Blinder among them. How extravagant a price to pay for what may be only a temporary reprieve from inflation—or worse, a misguided effort to solve a problem that doesn't exist. Because it's not clear that today's unemployment is low enough to push inflation higher.

The rate that would do that is known in economese as Nairu, for non-accelerating inflation rate of unemployment. When inflation began to speed up last year, most economists thought Nairu was around 6% or even 7%. They figured Blinder had gone soft in the head when he declared in 1987 that the rate was probably *below* 6%. But Blinder was right. Today, by most estimates, Nairu is between 5% and 6%. Now imagine what price the U.S. might have paid if, following the conventional wisdom, a hamfisted Fed had put the economy through a wringer in 1987 to head off inflation when unemployment dropped toward 6%.

What happened to confound yesterday's estimates? Two structural changes in the economy of the 1980s—the decline of unions and the growth of international competition—broke the easy postwar patterns in which big industries like steel and autos caved in to labor and passed the increased costs on to a captive marketplace. When labor markets tighten today, wages and prices do not go up in knee-jerk fashion. Says Nobel laureate James Tobin of Yale: "It seemed improbable 15 years ago that there would ever be such concessions and actual rollbacks in wages and benefits."




**Recession is a harsh antidote—but it works. Unemployment has to rise one point for a year to knock half a point off the inflation rate.**

In comparison with the dramatic penalties of recession, the costs of inflation are hard to pin down. Supposedly it is the "cruelest tax," victimizing most poignantly the elderly and others on fixed incomes. It plays havoc with financial planning and investment decisions and shifts wealth arbitrarily among groups. Shareholders and debtors gain, while bondholders and creditors lose. But doves such as Blinder argue that there aren't so many old folks on fixed incomes nowadays because Social Security payments are indexed. And variable-rate loans mean fewer gains for debtors at the expense of creditors.

All serious economists agree that a country has to counter inflationary surges by reining in demand. Where the doves peel off from the consensus is in their belief that *anticipated* inflation, the kind that reflects price expectations built up over time, is not much of a problem. When prices rise steadily and predictably, they say, wages, pensions, loans, and other contracts adjust.

In today's deregulated financial markets, for example, interest rates are more likely either to incorporate the anticipated rate as an inflation premium over the real rate or to float up and down with changes. That's true not only for corporate and government borrowing but even for the spending money consumers keep in interest-bearing checking accounts.

The trouble is, expectations change. A year ago inflation was 4%; this year it's closer to 5%. Those rates of inflation do creep up. If the nation decides 5% is acceptable but the political cost of maintaining it starts to rise, well, who's to say that 6% might not be acceptable—and 7% and so on? Too many people gain from inflation, not least the government's big spenders, who get more money without having to ask the voters for it.

*continued*

Yes, the doves do raise legitimate challenges to assumptions about the costs of steady inflation that hawks accept as holy writ. But the doves' arguments are not persuasive. While workers who are well organized or in tight labor markets may get their raises, the poor and the near poor have no such bargaining power. Their meager earnings may catch up to the rate of inflation eventually, but a couple of years of lagging behind can be rough when the prices of rental apartments and secondhand cars are rising. Inflation raises the cost of financial transactions and distorts investment patterns. A rate higher than those of major trading partners lowers living standards to the extent that it depresses the dollar. Financial markets will exact stiffer interest payments.

A tax code that ignores inflation creates more inequities. For example, the interest earnings that lenders get incorporate an inflation premium to cover the loss of principal, but all the earnings are taxed. Take a bondholder in the 28% bracket earning a nominal 9% on a Treasury bill when inflation is running at a steady 5%. Her effective interest is 4%, but she's taxed on the whole 9%, a 63% rate on the actual return.

Inflation gets clearly more painful when the rate accelerates. The higher and more volatile the rate, the more arbitrary the redistribution of wealth and the more time and energy everybody spends trying to outsmart the price spiral instead of producing useful goods and services. If foreign investors conclude that U.S. inflation is heading notably higher, their flight from the dollar could provoke the recession everyone wants to avoid.

RISING PRICES have to be resisted, but how? The job should be relatively simple today, when the inflation pressure is coming from an economy bumping up against its productive limits. The federal budget is a powerful tool for managing demand, and cutting it would cool the fevers. Though higher-than-anticipated tax revenues have shrunk the deficit 17.9% so far this fiscal year, Washington is dragging its feet on serious cost cutting. As a result, economists are talking again about some long-discredited alternatives.

That perennial favorite, wage and price controls, has failed every time and everywhere it has been tried, but visionaries keep dreaming up new approaches anyway. James K. Galbraith, an economist at the University of Texas and son of the eminent John Kenneth Galbraith, recently proposed an elaborate scheme that would synchronize all wage bargaining and peg cost-of-living adjustments not to past price increases but to a projection by the President for the coming year. Alas, there's no chance of getting labor and management to agree to such a system—even if it would work.

An older notion, the tax-based income policy, or TIP, would be easier to superimpose on the present system. It would use the tax code to penalize companies and employees for raises in excess of the inflation rate—or reward them if they settled for less. But if Americans didn't tip their hat to TIP when inflation hit double digits,

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**WHERE TO GET YOUR BASIC BURGERS** There's a Hard Rock Cafe in Tokyo if you have the wild craving for fries, and the quality of the hamburgers is superb.

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LOOK TO US NORTHWEST AIRLINES

there is less reason for them to do so now. Tobin, who urged an incomes policy in the late 1970s, has laid aside the quest, though he argues that the government should post guidelines and jawbone employers. A generalized threat by the Fed to crack down when inflation heats up is no threat at all, he argues, because people will keep struggling to improve their relative wages—cops will want more than firemen, Harvard professors more than their Yale colleagues. But who would heed the guidelines, either?

INDEXING remains popular with the if-you-can't-lick-'em-join-'em crowd. Blinder, for example, thinks it could solve the problem of the tax code's distortions. The capital gains schedule might incorporate a table of inflation factors to calculate increases for stocks or bonds bought in the past and sold during the tax year. The figuring could get complicated, he allows, but "it would be trivially simple compared to filling out a passive loss deduction form, which many of us have to do now."

## HEADING IT OFF

| COUNTRY | DEGREE OF CENTRAL BANK INDEPENDENCE | AVERAGE INFLATION RATE |
|---|---|---|
| Italy | ½ | 16.1% |
| Spain | 1 | 15.2% |
| New Zealand | 1 | 12.7% |
| Britain | 2 | 12.3% |
| Australia | 1 | 10.5% |
| France | 2 | 10.2% |
| Sweden | 2 | 9.8% |
| Denmark | 2 | 9.1% |
| Norway | 2 | 8.8% |
| Canada | 2 | 8.1% |
| United States | 3 | 7.2% |
| Belgium | 2 | 6.8% |
| Netherlands | 2 | 5.8% |
| Japan | 3 | 5.0% |
| West Germany | 4 | 4.1% |
| Switzerland | 4 | 4.0% |

SOURCE: NBER MACROECONOMICS ANNUAL 1988

**The scale runs from 0, totally beholden to politicians, to 4. Where the central bank is strong, citizens expect less inflation.**

But what kind of signal does indexing send? Economists Lawrence Summers of Harvard and Stanley Fischer argue that it may be useful if people do not expect prices to rise much anyway. Otherwise, it confirms suspicions that the government is not serious about fighting inflation.

Like it or not, a stern central bank, its gimlet eye fixed disapprovingly on the punch bowl, is the best line of defense. Because inflation in the short run usually means more growth and only minor price increases, elected officials are constantly tempted to tolerate it. It's no coincidence, Summers says, that countries whose central banks are highly independent of other government policymakers do best at containing inflation (see table).

Though the Fed's policies have raised short-term interest rates over the past year, long-term rates have held steady, implying that the financial markets don't expect the inflation rate to rise. Confirmation comes from the most recent survey of institutional investors by Drexel Burnham Lambert's chief economist, Richard B. Hoey. They anticipate a rate of about 4.7% over the next decade—practically the lowest rate they've foreseen since Hoey began surveying in 1978. *continued*


So before you go, dig out some of your old records and practice up.

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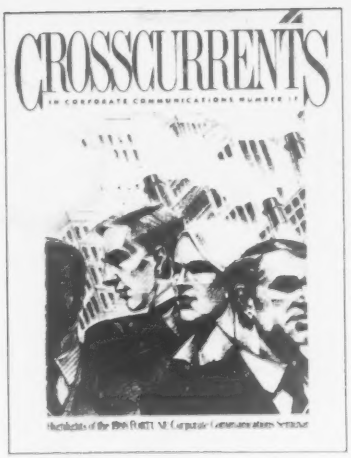
# CORPORATE IDENTITY
# RESTRUCTURING
# TAKEOVERS
# OUR AGING POPULATION
# GLOBAL COMPETITION

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## THE ECONOMY

In congressional testimony last spring, Alan Greenspan said his long-term goal is a rate of inflation "approximating zero," implying that anything much higher will sooner or later fail the expectations test. Cleveland's Hoskins, one of the Federal Reserve Board's superhawks, has a detailed plan for reaching zero. But his Godzilla gambit implies regular bouts of recession—or the risk of them—and seems no more politically viable than an incomes policy.

THE FED, he says, should declare that it is committed to reducing inflation gradually over the next three to five years until the average annual rate is zero. It should spell out its plan by setting an upper limit on a broad price measure like the CPI, and then knock that limit down by a percentage point a year. After any month in which the CPI rose above the prevailing cap, the Fed's goal—or in Hoskins's take-no-prisoners words, its "single, dominant, all-inclusive objective, without regard to any other objective of policy"—would be to bring the CPI under its limit again, even at the cost of inducing a recession.

Most economists suspect that zero inflation is not a practical target, if only for technical reasons. Poor measurements of productivity in service industries, for example, tend to overstate inflation by understating actual output gains. In the end even Hoskins hedges slightly by defining zero as less than 1% a year.

The principle of reducing inflation to the lowest technically feasible rate leaves room for some disagreement about the actual level. During the 1950s most economists accepted the prevailing 1.5% as equivalent to zero inflation. The West Germans become anxious at 1% or less, the Swiss at 2%, and the Japanese at 2.5%. The main point is that keeping inflation stable at *any* rate means convincing people that there will be no acceleration. The faster prices rise, the harder it is for a government or central bank to remain credible.

Americans fear inflation deeply because they understand that small doses make life easier for more people than care to admit it. Like the vices of prim Victorians, the enjoyment of inflation is best practiced on the sly if it's indulged in at all. Letting it into the parlor raises the terrifying prospect that it will race out of control, like so many other vices. As First Boston economist Albert M. Wojnilower puts it, "We've delegated the conscience that governs us, but it remains our own." F